

# Roosevelt Investments Market Commentary

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## **Fourth Quarter 2011**

*Late November's coordinated easing by the Fed, the European Central Bank (ECB), and four other major central banks globally marked a rarely used, yet powerful signal to capital markets. Central bankers demonstrated they were more than willing to use tools at their disposal to halt the emerging near-term liquidity crisis faced by banks in Europe and prevent its spread to other parts of the world. This easing, along with further actions by the ECB, helped to stabilize the U.S. stock market against the backdrop of our economy which continues to recover. We reduced our risk tools in response to these events and hold a constructive outlook as we begin the new year.*

## **Decoupling**

Concerns regarding the Eurozone's fiscal issues, which were the focus of investors for much of 2011, reached extreme levels in the fourth quarter. In an eerie echo of the period immediately after Lehman Brothers filed for bankruptcy in 2008, Europe's banking system nearly froze up. Investors grew anxious about sickly bank balance sheets and the possibility that if marked to market, sovereign debt would result in losses that force banks to raise capital. As interbank lending rates rose to crisis levels in late November, the liquidity logjam was broken by way of an agreement between the ECB, the Federal Reserve, and a handful of other central banks to provide dollar funding "swap lines" at low interest rates. This sent a strong signal that central banks would not stand by and watch another crisis take place.

Having ameliorated the European banking system's near-term liquidity crisis, the ECB turned its attention to intermediate-term funding and in December initiated the three-year Long Term Refinancing Operation (LTRO). European banks were provided extremely low cost funding with the suggestion that such funds be used to purchase sovereign debt of the country in which a given bank is domiciled. (The uptake on this ECB LTRO was over \$600 billion, nearly double what had been estimated.)



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In this fashion, the ECB helped provide a more liquid market for sovereign debt. A good portion of the banking system's 2012 debt maturity and refunding needs were also covered by this lending facility. We believe this facility, along with the U.S. dollar swap agreement mentioned above, are akin to quantitative easing actions. Such an environment should have a favorable impact upon capital markets.

In a welcome reprieve for investors, the U.S. economy appears to have found its footing, despite the continued uncertainty in Europe. While Europe continues to stumble, our economy is enjoying an upward trajectory, having exceeded expectations for several months running. In September, consumer spending and capital goods orders started to improve. Generally good third quarter earnings reports followed. And, as the fourth quarter progressed, consumer confidence rose to a six-month high, unemployment fell to a three-year low, bank lending began expanding at the fastest pace in several years, particularly to credit-strapped smaller companies, and even the beleaguered homebuilding sector started to pick up. Automobile sales began ticking higher and manufacturing activity hit its fastest pace in six months. In addition, the level of inflation has declined, providing consumers with greater purchasing power and the Fed with greater leeway since its easing policies have not caused inflationary pressure to date.

It may seem odd that the U.S. economy would improve when much of Europe faces a possible recession, but these two major economies have diverged from time to time, with three such periods occurring in the past fifteen years. In addition, with services and consumer spending driving 70% of the U.S. economy, it is less dependent on exports than some other major economic powerhouses, such as China and the Eurozone.

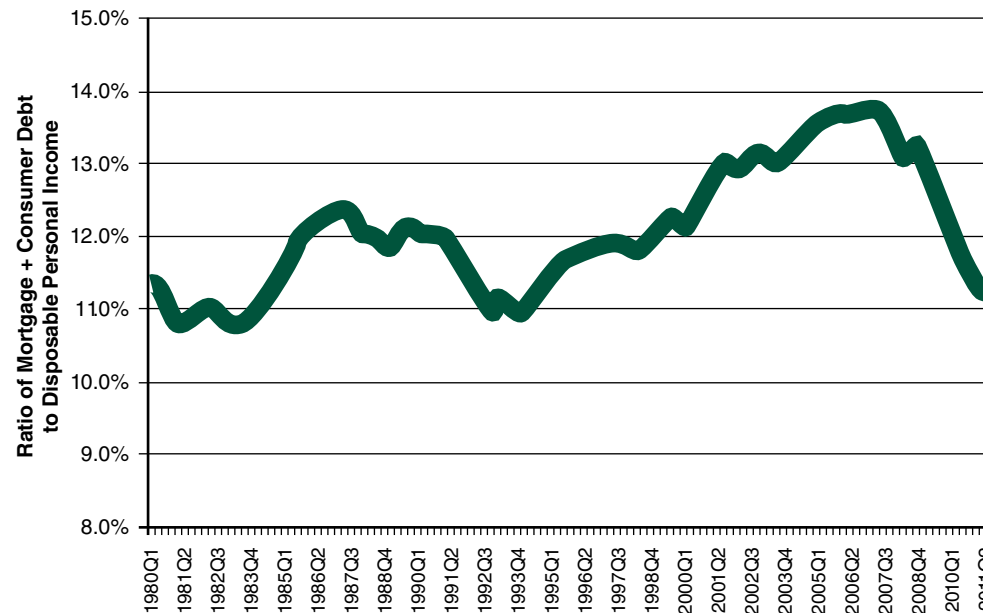


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**The accompanying chart illustrates that household debt, per disposable income, has decreased since the housing bubble to approximate levels seen in the early 1980s and '90s. This indicates to us that the consumer is not as stretched as may be generally believed.**

The U.S. consumer has both de-levered and benefited from lower interest rates to a much greater degree than may be appreciated (see chart below). The household debt service ratio, an estimate of the ratio of debt payments to disposable personal income, has ranged from under 11 in the early 1980s and early 1990s to as high as 13.96 at the peak of the housing bubble, and currently sits near 11, which indicates to us that the consumer is not as stretched as may be generally believed.

**Federal Reserve Board  
Household Debt Service Ratio**



# Roosevelt Investments Market Commentary, Cont'd.

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The U.S. economy now appears to be on a path to self-sustaining growth – a much different scenario than that of several months ago, when the markets were abuzz with fears of a recession. In fact, economists have increased their GDP growth forecasts for the fourth quarter to an estimated 3%, up from closer to 2% in November. Some of the economic data support GDP near 4%, and if it turns out that our economy did grow 3% to 4% in the fourth quarter, then current estimates of 2.3% for the full year 2012, which include a first-half slowdown, may have to be raised.

## **Review and Outlook**

Roosevelt's All-Cap Core portfolio underperformed the broader market in 2011. The market's tone was characterized by persistently high volatility and record high levels of correlation among stocks, and erratic swings generally driven by politics and policy rather than company-level fundamentals. Primary examples included Europe's sovereign debt crisis and Congress' failure to resolve the U.S. debt ceiling debate, which contributed to a 200-point drop in the S&P 500 index in August. The press often invoked the phrase "risk-on, risk-off" to describe the bi-polar nature of the market on any given day. Under such conditions, stock selection and our thematic approach to alpha generation proved to be challenging. Only one in six active managers outperformed the S&P 500 index in 2011, the worst record since 1997.<sup>1</sup> Hedge funds also fared poorly in 2011, with the Dow Jones Credit Suisse Hedge Fund Index (a database of 8,000 hedge funds) declining by 7.4%. Much of the investment community was out of position for key moves in the market, particularly in the second half of the year. The dramatic August selloff surprised many managers and caused a shift toward a more defensive approach that backfired when the market rallied in October and again in late November.

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<sup>1</sup> Empirical Research Partners, January 6, 2012.



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**We are now better positioned to capture upside reflecting the improving US economy as well as the recent actions taken by the ECB to enhance market liquidity.**

While Roosevelt's portfolio continued to protect against market declines, some upside was missed because of the pernicious risk profile and volatility brought about by events in Europe. We are now better positioned to capture upside reflecting the improving US economy as well as the recent actions taken by the ECB to enhance market liquidity. We are encouraged by the current low inflationary environment, continuing corporate profits growth, and the improving employment picture. While we are not making the case for a robust US economy, we do see it as improving and thereby less vulnerable to the potential for further negative shocks emanating from Europe.

**Roosevelt Investments**

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